Brighton Jones®

Q2 2023
Investment Update

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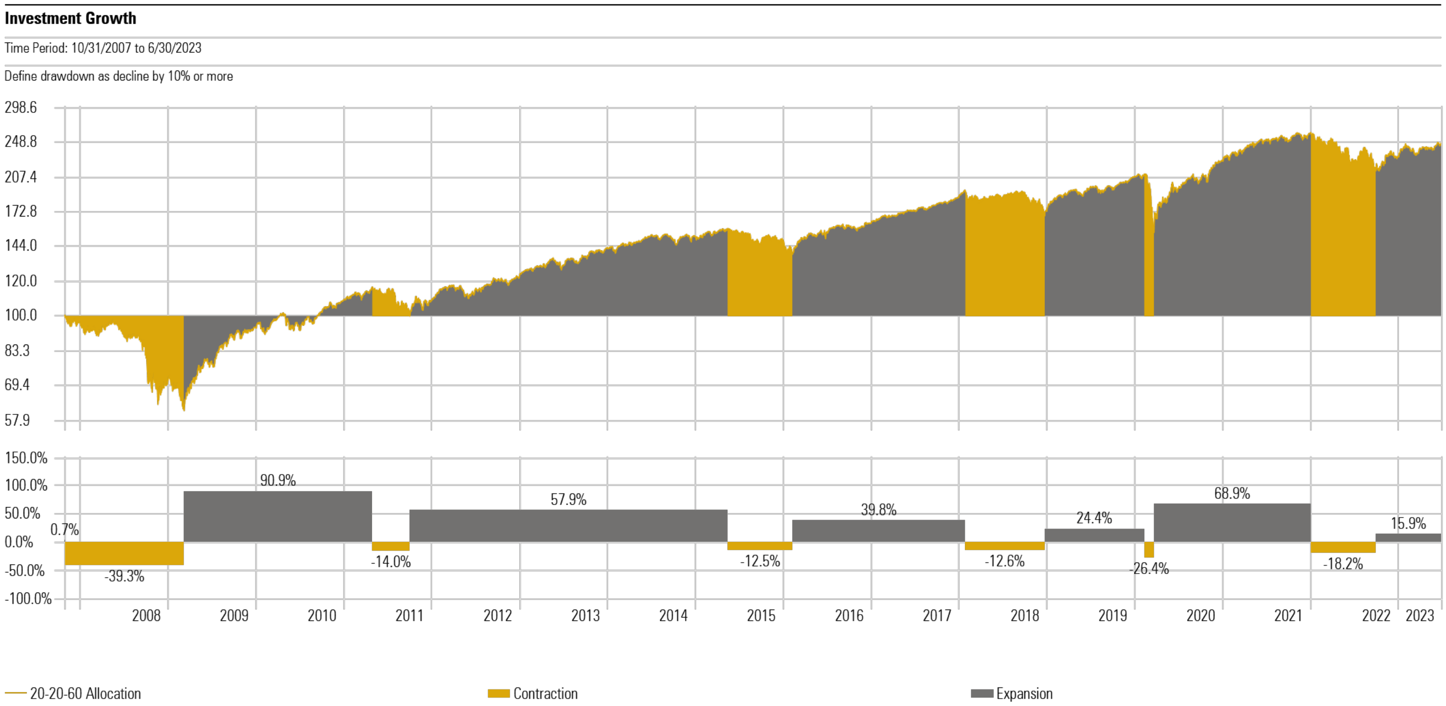
Contents

Expansions and Contractions: 60% Equity Portfolio



About this Slide: This chart shows the growth of a moderate risk portfolio—with a 60% weighting to stocks—since the peak of the market before the 2008 global financial crisis. The bottom half of the page shows the length and magnitude of expansionary and contractionary periods during the [approximate] fifteen years shown.

Key Takeaways:

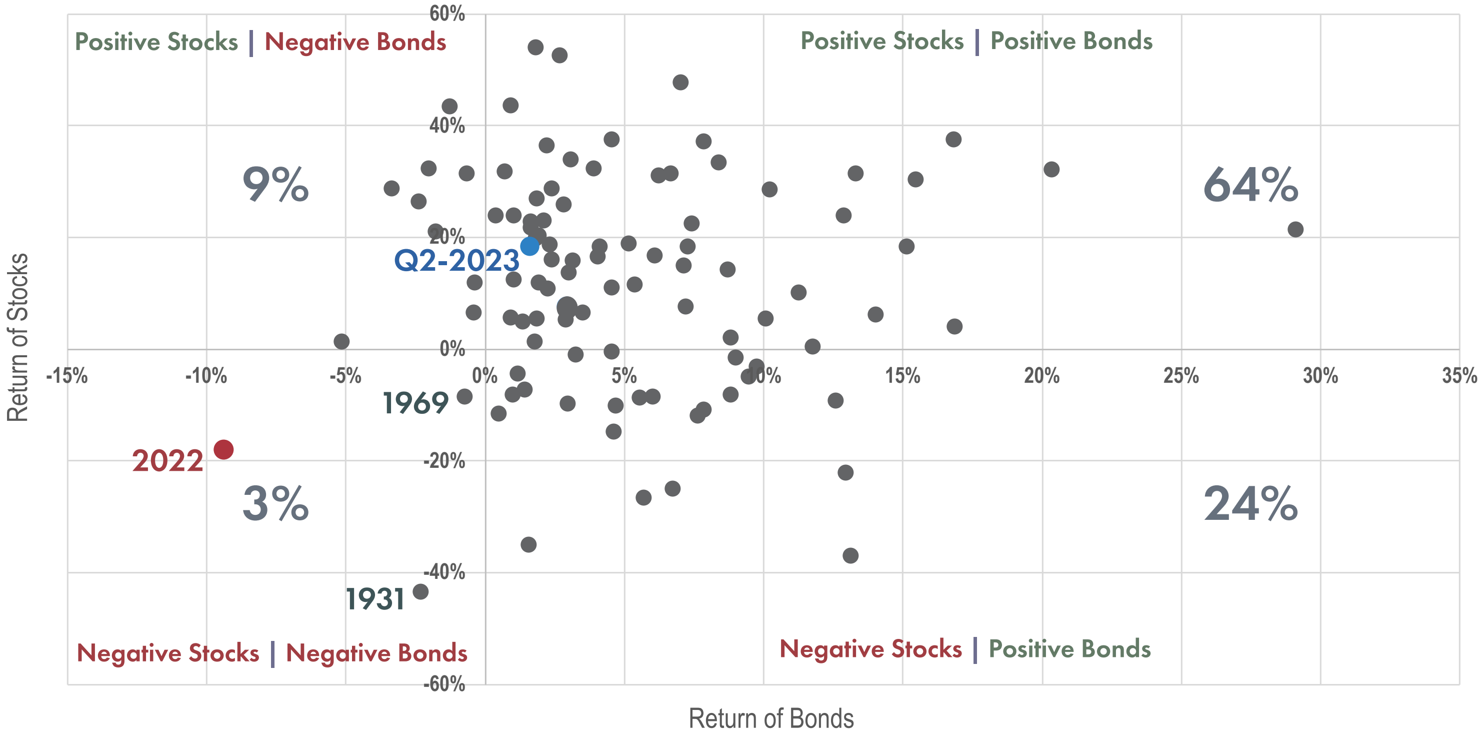
- Over the past fifteen years, a diversified portfolio has experienced a drawdown of 10% or more on six occasions. Last year's peak-to-trough decline of roughly 18% over 269 days (9 months) closely matched the average experience of the five previous episodes, which saw an average peak-to-trough decline of roughly 20% over 258 days.

- Without any notable or concrete catalysts to speak of at the time, diversified portfolios found a bottom on September 30th and have rallied nearly 16% over the past nine months. This serves as reminder that capital markets will never send an "all clear" signal for us to invest near the bottom, and if we wait for one to appear, chances are markets will climb higher as we keep waiting. Indeed, the recent gains have coincided with continued interest rate hikes, firmer-than-hoped-for inflation readings, a regional banking panic, and fears that the US might default on its debt obligations due to a power struggle in congress over the debt limit.

Data Disclosures: *Moderate Risk Portfolio: 10% Short-Term Bonds, 10% Intermediate-Term Bonds, 4% Inflation-Protected Bonds, 4% Multisector Bonds, 4% Floating Rate Bonds, 4% High Yield Bonds, 4% Preferred Securities, 34.5% US Stocks, 18% International Stocks, 4.5% Global Real Estate, 3% Master Limited Partnerships. The foregoing information is provided for discussion purposes only and should not be relied upon as indicating any expected or projected returns. Hypothetical back-tested performance does not represent actual performance, trading costs or the impact of taxes and should not be interpreted as an indication of such performance.*

Data source: Morningstar Direct.

Calendar Year Returns: Stocks vs. Bonds (01/1926 – 06/2023)



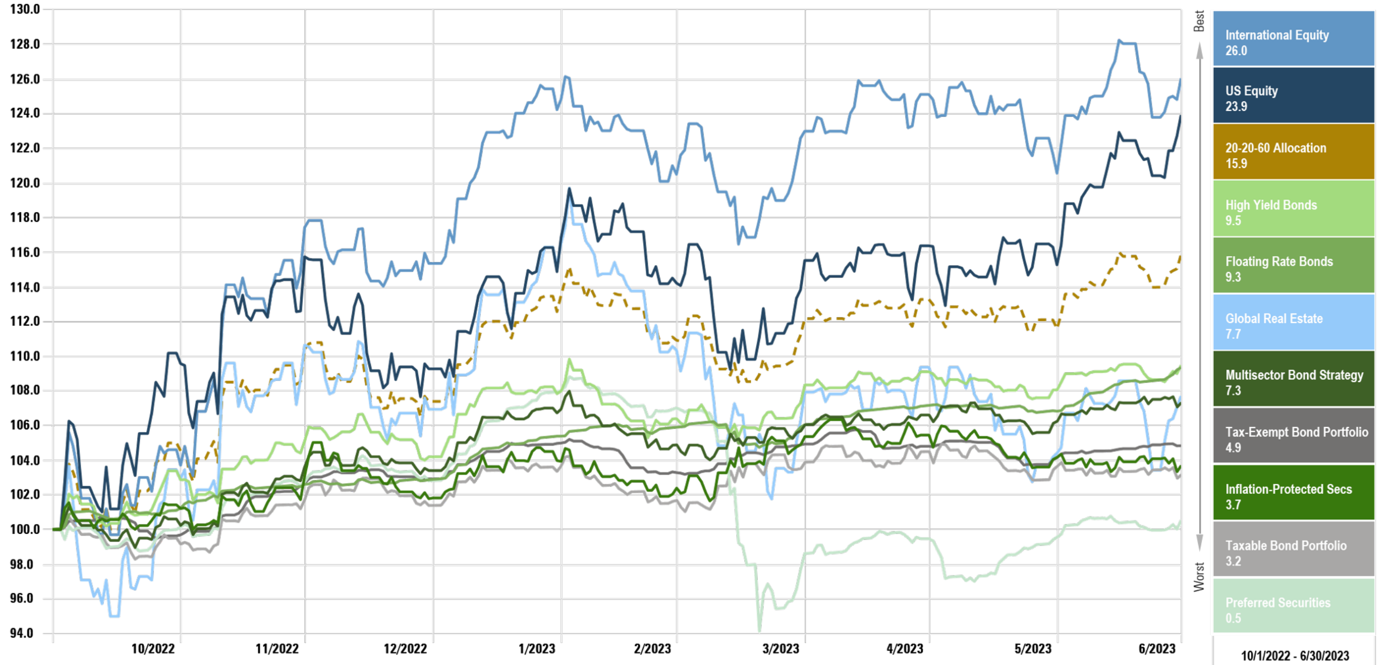
About this Slide: This chart plots the calendar year returns of 5-year Treasury Bonds on the horizontal axis against the calendar year returns of the S&P 500 Index on the vertical axis since 1926. This visual offers an easy way for investors to assess the probability of earning positive or negative calendar year returns for fixed income and equity securities in isolation or jointly together (of course, past performance may not be a reliable indicator of future results). For example, to calculate the probability of earning a positive return in fixed income, we can add the two quadrants on the right-hand side together (24% + 64% = 88%); and if we want to identify the probability of earning a positive return in both fixed income and equities, we can just look to the upper right quadrant (64%).

Key Takeaways:

- In 2022, both fixed income and equity markets posted negative returns. This outcome has historically been extremely rare and occurred only twice before last year since 1926.
- As humans, we often extrapolate recent trends. For example, many investors feared a repeat of 2022 with further losses in both fixed income and equity markets throughout 2023.
- Using history as our guide, a repeat of 2022 appeared unlikely heading into 2023.
- Through the first half of 2023, we are off to a good start with positive returns in both fixed income and equity markets.
- One of our core investment principles states that "thinking probabilistically improves decision making." This is one example of how we can consider a range of possible outcomes that might come to pass and test ideas with historical data.

Data Source: Dimensional Returns 2.0.

Component Performance: Tracking the Recovery



About this Chart: This chart shows performance for the core market segments within our portfolios since September 30, 2022—the low point for a diversified portfolio in the current market cycle.

Key Takeaways:

- On September 30, the target range for the Federal Funds Rate was 3.00% to 3.25%. In the six interest rate policy meetings that have taken place since, the Federal Reserve has increased the range to 5.00% to 5.25%. Despite continued interest rate hikes, fixed income markets have rallied sharply over the past nine months.

- While diversified portfolios reached a low on September 30th, the US Aggregate Bond Market Index did not reach its low until October 24. The US Aggregate Bond Market Index returned 6.7% from its low to the end of Q2-2023. This once again shows that fixed income markets typically find a bottom before the Federal Reserve is done raising interest rates and, similar to equity markets, it can be a costly mistake to sell bonds after a price decline hoping to sidestep further declines.

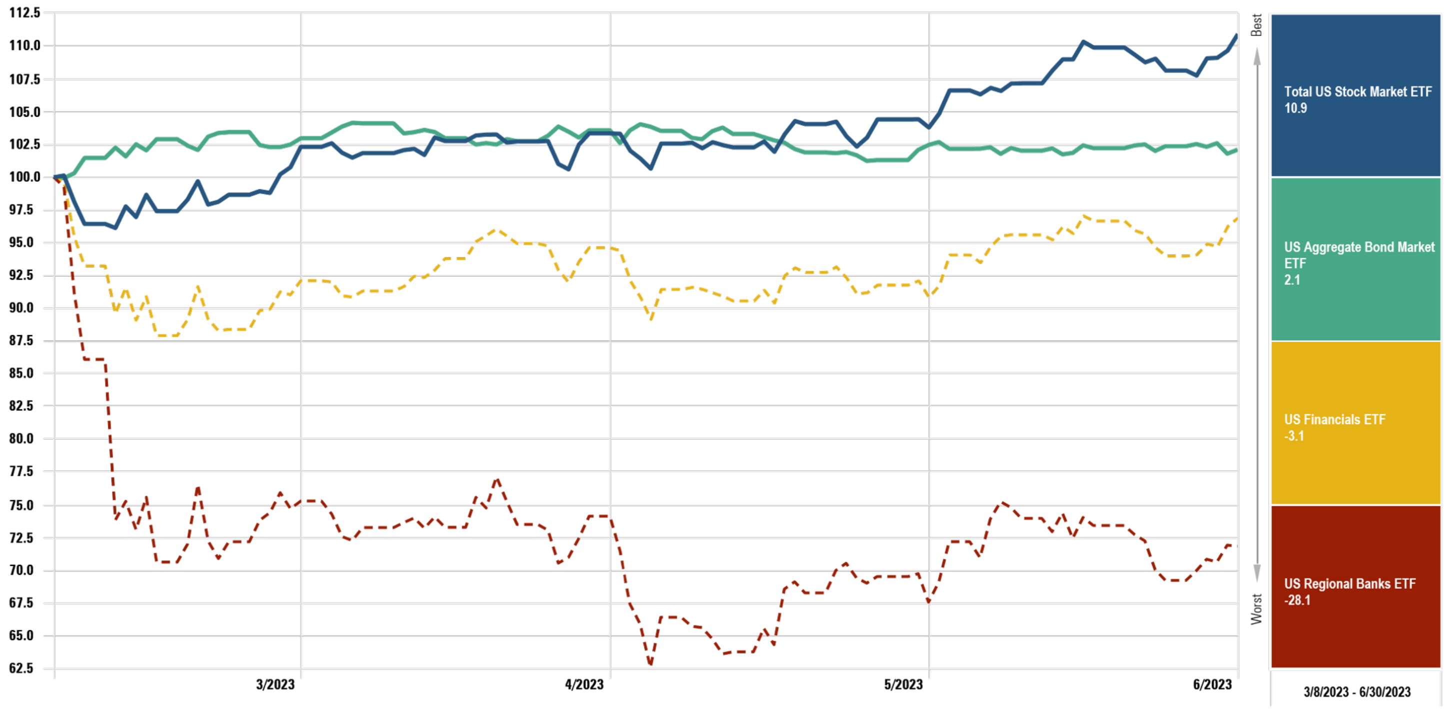
- With the war between Ukraine and Russia creating uncertainty across Europe and China's strict COVID policies shutting down the world's largest economy outside the US throughout much of 2022, many clients expressed some level of concern over their international equity allocation. But in performance reviews with clients, it came as a surprise to many that international markets outperformed the US market last calendar year and have modestly outperformed throughout the sharp rally over the past nine months.

- One of our investment principles states that price—not quality—is the primary determinant of risk. One interpretation of this statement is that few opportunities are so inherently bad that they cannot become a good investment if bought cheap enough. The combination of depressed expectations and low relative valuations for international markets help explain what can sometimes feel like a disconnect between financial markets, economic performance, and current news headlines.

- The lone exception to an otherwise solid performance scorecard are Preferred Stocks. Preferred Stocks had rallied sharply along side high yield bonds (initially up more than 8% from September through January) but gave up the gains during the regional banking scare (financial institutions are among the largest issuers of preferred equity). However, as the asset class experienced indiscriminate selling pressure, preferred stock yields jumped into the high single-digits. The selling pressure now appears to be in the rearview mirror with the market segment starting to recover.

Data Disclosures: *Taxable Bond Portfolio: 50% Vanguard Short-Term Bond Index + 50% Vanguard Total Bond Market. Tax-Exempt Bond Portfolio: 50% Vanguard Limited-Term Tax-Exempt + 50% Vanguard Intermediate-Term Tax Exempt. Inflation-Protected Bonds: Vanguard Inflation-Protected Securities. Multisector Bond Strategy: PIMCO Income. Floating Rate Bonds: Fidelity Floating Rate. High Yield Bonds: PIMCO High Yield. Preferred Securities: Nuveen Preferred Securities. US Equity: DFA US Core Equity I. International Equity: DFA World ex US Core Equity. Global Real Estate: DFA Global Real Estate.*
Data source: Morningstar Direct.

Muted Reaction to the Regional Bank Scare



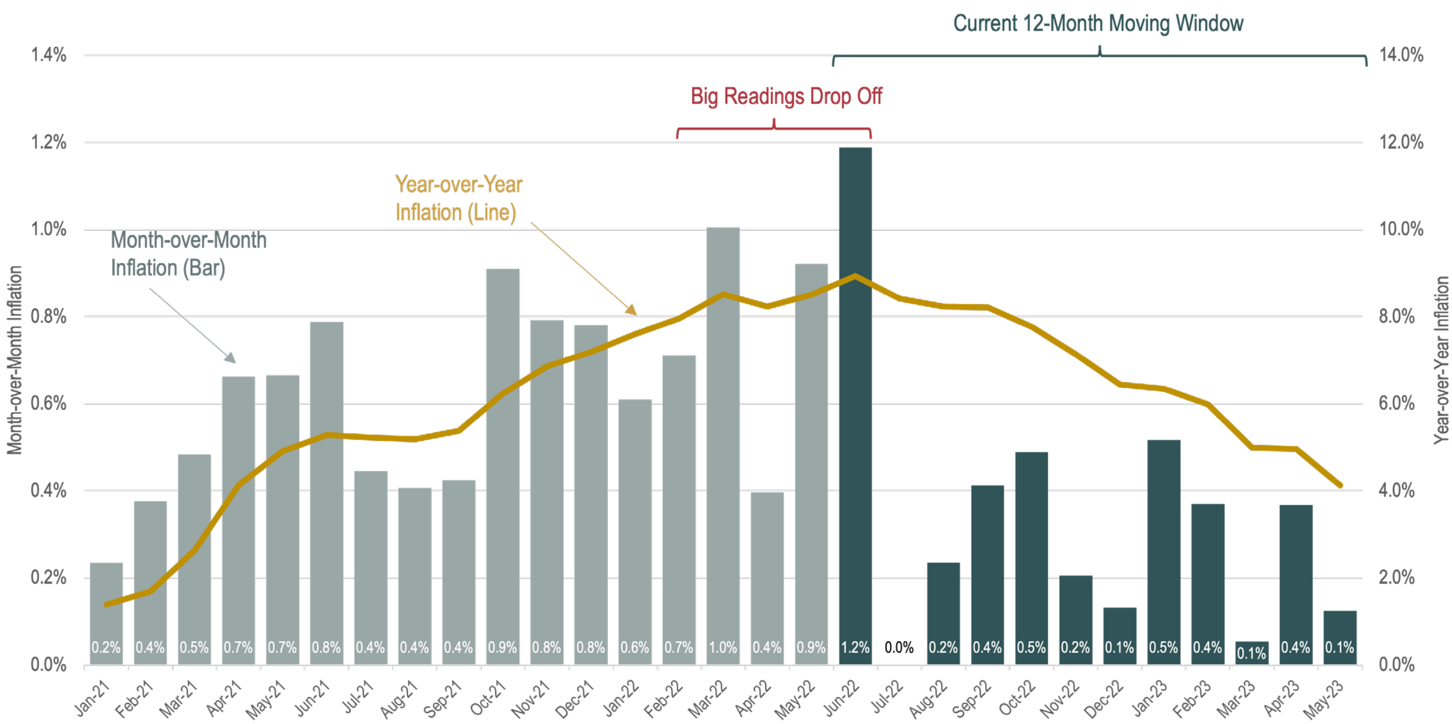
About this Chart: This chart shows the performance exchange-traded funds representing the US Aggregate Bond Market, US Total Stock Market, US Financial Sector, and US Regional Banks since March 8, the date Silicon Valley Bank revealed they liquidated approximately $20 billion of treasury and mortgage-backed securities at nearly a $2 billion loss and would seek to raise additional capital.

Key Takeaways:

- As we often say, successfully timing markets requires investors to be right twice—you have to know when to move to cash at the right time, and you have to reinvest before markets recover and push higher beyond the point at which you sold. What played out as the regional banking scare unfolded is likely to have tripped up even the most seasoned traders.
- While regional banks were punished with nearly a 40% decline and the rest of the financial sector was dragged as much as 12% lower, the US Stock Market suffered only a moderate decline before resuming its upward trend.
- As of quarter-end, the US Stock Market was 10.9% higher from its March 8th level.
- In retrospect, knowing how stock and bond markets performed, a well-reasoned explanation is that investors welcomed the apparent challenges in the banking sector because the Federal Reserve may not have to raise interest rates as high as they otherwise would have (absent the banking panic). Indeed, market-reasoning can be a convoluted exercise. That's why it's so hard to successfully outperform by timing markets and picking individual stocks. Conventional thinking—such as selling stocks at the onset of a potential regional bank run—is likely to land investors in trouble more often than not.

Data Source: Morningstar Direct.

Inflation Trends



About this Chart: This chart shows month-over-month inflation (bars, left axis) and year-over-year inflation (line, right axis). Bars shaded in dark blue represent the most recent 12-month period, over which inflation averaged 4.1%, down from 6% as of our last quarterly update.

Key Takeaways:

- Elevated inflation has been an ongoing concern for consumers and a key driver of investment returns across fixed income and equity markets. Consumers and investors alike are anxiously monitoring inflation trends and hoping for signs that price pressures will continue to ease (from a peak year-over-year inflation rate of 9% registered June 2022).

- Headlines typically focus on year-over-year inflation but looking at monthly inflation readings can reveal potential trends sooner. In identifying emerging trends, it's helpful to visualize the annual inflation rate as a 12-month moving window, where each month the oldest number drops off and is replaced by a newly revealed number.

- Many economists predicted earlier this year that inflation would decline at a rapid pace through June of 2023. This isn't because they have a crystal ball and knew what the future inflation readings would be. They simply looked at the data and could see that a stretch of large readings in excess of 1% would drop out of the twelve-month moving window starting in March. Hence, predictions saying that inflation would come down was more or less a guess that the monthly numbers dropping out of the twelve-month moving window would be replaced by smaller numbers. Indeed, that is exactly what happened since our last update at the end of the first quarter.

- Looking ahead, we are likely to see one more significant drop in the year-over-year inflation rate as a 1.2% reading will fall out of the 12-month moving window. This could put year-over-year inflation in the low-to-mid 3% range. However, we could see inflation tick higher later this summer as we will no longer have large numbers falling out of the moving window. This is why the Federal Reserve has indicated they may not be done raising interest rates to battle inflation.

Data Source: U.S. Bureau of Labor Statistics

US Treasuries vs. Certificates of Deposit

	Yields						
	3mo	6mo	9mo	1yr	2yr	3yr	5yr
U.S. Treasuries	5.38%	5.47%	5.47%	5.48%	5.14%	4.78%	4.44%
CDs (New Issues)	5.20%	5.30%	5.35%	5.45%	5.40%	5.40%	5.40%

Description	Coupon	Coupon Frequency	Maturity Date	Fractional CD	Yield	Call Protected	Settlement Date	Quantity Available	Attributes	Period
GREAT MIDWEST BANK SSB	5.400	MONTHLY	07/14/2028	No	5.400	No	07/14/2023	2,675	SFP FDIC SO SKY	5 YR
STATE BANK OF BOTTINEAU	5.350	SEMIANNUAL	07/07/2028	No	5.350	No	07/07/2023	609	SFP FDIC SO	5 YR
BIPPUS STATE BANK	5.350	MONTHLY	07/10/2028	No	5.350	No	07/10/2023	671	SFP FDIC SO SKY	5 YR
INTEGRITY BANK & TRUST	5.350	MONTHLY	07/11/2028	No	5.350	No	07/11/2023	2	SFP FDIC SO SKY	5 YR
BMO HARRIS BANK NA	5.350	QUARTERLY	07/14/2028	No	5.350	No	07/14/2023	2,690	SFP FDIC SO	5 YR
HIAWATHA NATIONAL BANK	5.350	MONTHLY	07/19/2028	No	5.350	No	07/19/2023	2,100	SFP FDIC SO SKY	5 YR
METHOD BANK	5.300	MONTHLY	07/14/2028	No	5.300	No	07/14/2023	809	SFP FDIC SO	5 YR
JP MORGAN CHASE	5.150	SEMIANNUAL	07/11/2028	No	5.150	No	07/11/2023	6,718	SFP FDIC SO	5 YR

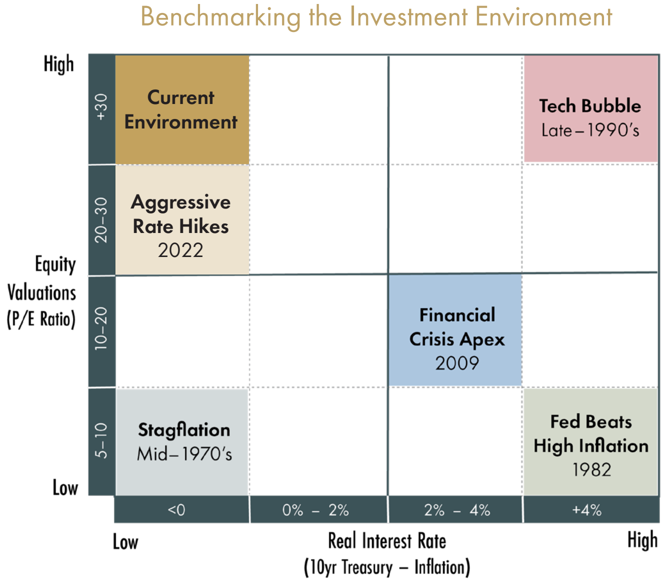
About this Chart: With interest rates moving to their highest level since 2007, many clients have asked about purchasing Certificates of Deposit (CDs). The first section of this slide compares prevailing yields for US Treasuries and CDs. The second section shows, for illustrative purposes only, currently available CD issuances with a 5-year term.

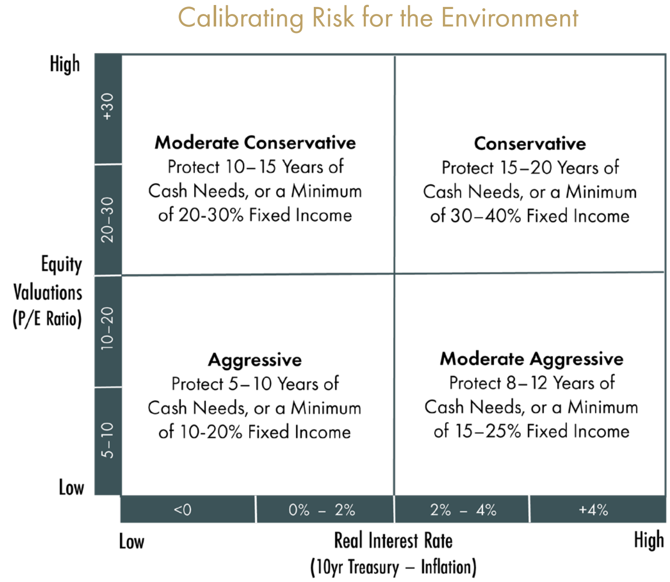
Key Takeaways:

- We have observed over the past year that US Treasuries offer slightly higher yields than CDs for terms of one year or less.
- Longer-term CDs appear to offer materially higher yields than Treasuries with the same maturity. But is this too good to be true?
- Looking under the hood of the 5-year CD issuances currently available at Fidelity, we can see the reason for the higher yields—they tend to be "callable" by the issuing bank.
- A call feature allows an issuing bank to redeem a CD prior to its stated maturity, typically as early as 6 months from the origination date.
- The call feature is a win-win for the issuing bank (at the expense of the buyer of the CD)
  — If interest rates decline, the issuing bank will exercise its option to redeem outstanding CDs early.
  — If interest rates rise, the issuing bank will have locked in access to cheaper capital for an extended period.
- An investor would be better off rolling over 6-month Treasuries yielding ~5.4% than buying a 5-year CD yielding 5.4% that becomes callable starting in 6-months.
  — If interest rates rise, buying the 6-month Treasury would allow the investor to reinvest at a higher interest rate upon maturity.
  — If interest rates decline, both the buyer of the 6-month Treasury and the buyer of a callable CD face the same reinvestment risk.
- Given Treasury securities are far more liquid than CDs (important if you ever need to sell prior to maturity) and income derived from Treasury securities is not taxable at the state level, we favor Treasuries over CDs where the two offerings are otherwise comparable.
- This is an important reminder that whenever there appears to be a free lunch, there's usually more research to do.

Data source: Fidelity.com

Calibrating Portfolio Positioning





About this Slide:

Historical stock market data reveals there is a strong inverse relationship between starting equity valuations and future equity returns over an intermediate time frame of 10-15 years. When starting valuations are low, future returns tend to be above average, and vice versa. Historical bond market data reveals a strong positive relationship between current yields and future fixed income returns. For example, an investor who buys a 5-year bond yielding 4% can expect to earn very close to 4% per year over the term of the bond (the only unknown component to the nominal return of a fixed income security held to maturity is the future interest rate at which income is assumed to be reinvested). Using this information, we benchmark the current investment environment by deriving absolute return expectations for fixed income and equity markets in isolation as well as relative return expectations between the two asset types (since asset classes are competing against each other for our dollars via expected returns). This exercise helps us determine our portfolio positioning (i.e. the percentage weights of fixed income and equity securities) when equity valuations are high/low and real (inflation-adjusted) interest rates are high/low.

The diagram on the left illustrates how we characterize the investment environment using a quadrant chart with inflation-adjusted treasury yields on the horizontal axis and equity valuations on the vertical axis. Along each axis, we denote the breakpoints used for segmentation; and within each quadrant we identify at least one period that stands out as having historical significance. We then calibrate our allocation positioning according to the quadrant chart on the right. When equity valuations are low (bottom half), we want increased exposure to stocks, all else equal. When real interest rates are high (right half), we want increased exposure to bonds, all else equal. Importantly, we consider allocation adjustments when there are changes in the relative attractiveness of fixed income and equity market segments. For the past several years, the investment environment has fallen in the upper left quadrant. With large movements in fixed income and equity markets, clients might be wondering what we look for when considering adjustments to our investment strategy.

Key Takeaways:

- Despite rising interest rates and volatile equity markets, we have not categorically shifted into a different investment environment.
- Nominal interest rates have increased dramatically, but the 10-year Treasury yield remains slightly negative adjusted for inflation.
- Equity valuations came down modestly during last years' sell-off, but stocks never looked to offer the type of generational buying opportunity like those seen in 1982 and 2009.
- Over the past nine months, the S&P 500 Index has risen 26%, yet reported earnings have declined. This has kept the price-to-earnings ratio of the US market in elevated territory.
- We believe our current portfolio positioning with a "moderate conservative" stance towards risk has us appropriately balanced for the time being.
- Of course, we will consider adjustments as warranted by a changing investment environment; but we want to refrain from making changes just for the sake of making changes.

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